



Office of the City Auditor

Tangible Property Asset Management Report No. 0407B

April 21, 2005

Positive steps have been taken in an effort to maintain an accurate list of capital equipment, which in turn facilitates the safeguarding of these assets. However, additional steps could further improve controls over these items.

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April 21, 2005

To the Most Honorable Mary Manross, Mayor
and Members of the Scottsdale City Council

Transmitted herewith is a report on Tangible Property Asset Management, Report No. 0407B. While completing this work, two issues came to our attention that we believe need to be addressed. These issues, presented below, fall outside the scope of this audit and, therefore, were not exhaustively pursued.

We noted that there were expenditures against Capital Improvement Project (CIP) cost centers which we could not trace to the capital improvement plan budget book. The CIP Coordinator position is currently not filled and, as a result, we could not obtain any readily available insight into why this situation exists.

We also noted that vendor supplies are kept in the City Warehouse on consignment to facilitate City access to items on an as needed basis. The City does not pay the vendor for items until they are used. This raised the question as to whether a competitive bid process was used to select the vendor and whether the selection needs to be revisited. The value of vendor supplies on consignment was estimated to be \$60,000 as of June 30, 2004. However, this provides no insight into the number of times inventory may turnover throughout the year. After the close of fieldwork, the Purchasing Director relayed to us that the supplies were on consignment as part of a 2004 contract that was secured through a competitive selection process. We did no further work on the topic.

If you need additional information or have questions, please contact me at 480-312-7756.

Respectfully submitted,

A handwritten signature in cursive script that reads "Cheryl Lee Barcala".

Cheryl Barcala, CPA, CIA, CFE, CGFM, CISA, CISSP
City Auditor

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EXECUTIVE SUMMARY

An audit of the City's asset management system was included on the 2002/03 Audit Plan for our Office and was reaffirmed by the Audit Committee in December 2004. The purpose of the work addressed in this report was to determine whether controls are in place to provide reasonable assurance that the City's tangible assets (excluding real property, vehicles and equipment tracked by Fleet, and the assets tracked by Information Systems) are adequately safeguarded.

The City maintains a wide variety of tangible assets as a function of the various activities associated with City government. Items within this classification may range from pumps and ancillary equipment to office furniture. This audit was initiated to ensure that a satisfactory system of internal control existed to adequately safeguard these assets.

In early 2003, City management developed a new Administrative Regulation (AR) addressing capital assets. As part of this AR, management formalized the threshold to be used in determining when an item should be capitalized and tracked. Under current practice, only items (or network of items) with a cost of \$5,000 or more and useful lives greater than one year are considered capital assets. As a result, this report will focus on controls in place to track capital assets. On page 14 we discuss the need for an AR to set out policies and procedures for tracking the non-capital assets with an expected life exceeding a year. In absence of a directive to track these items either at the department level or citywide, the City will lose any historical record of items such as office desks, chairs, tables, and small tools purchased with City funds but not meeting the \$5,000 threshold.

We noted that many positive steps have been taken in an effort to maintain an accurate list of capital equipment, which in turn facilitates the safeguarding of the assets. Processes have been established to identify equipment that should be recorded onto, or taken off of, the capital asset list. In addition, Accounting has initiated an annual verification process that addresses at least a portion of the equipment on this list. However, we found that improvements are needed to help ensure consistent criteria are applied in identifying equipment to be added to the capital asset list. Obtaining and reviewing detailed supporting documentation on each equipment acquisition should help provide necessary insight for this purpose. It should also provide needed insight to comply with AR requirements for tagging capital equipment. In addition, retrieving asset tags from capital equipment at the time it leaves the City could serve as evidence that the items were appropriately disposed of. Moreover, as currently structured, the capital equipment inventory verification process omits nearly 90 percent of the dollar value of the items. Detailed

descriptions of the equipment on the capital asset list would facilitate a more thorough inventory verification. In addition, high-risk capital equipment should be identified for the purpose of implementing a more directed verification process.

The Action Plan on the following pages details our recommendations, management's responses to those recommendations, and the implementation status of management actions. Management's response can be found in Appendix A.

ACTION PLAN

No.	Recommendations and Management Response
	The Financial Services General Manager should ensure that steps are taken to:
1	<p>Develop citywide guidance that establishes responsibility for assessing the need to track high-risk tangible equipment that does not meet the \$5,000 capitalization threshold, but which have useful lives in excess of one year. Provide direction on what items may be considered high risk and thus merit establishment of safeguarding controls. Either establish controls that should be implemented at the user level or provide a list of potential control techniques that could be implemented at the discretion of the user department.</p>
	<p>Management Response: Concur. Language will be added to Administrative Regulation 226, to encourage program managers to identify and track high risk items.</p> <p>It should be noted that the City has very strong compensating controls in this area. The City's budgetary controls help to ensure that managers, supervisors and upper management are accountable for requesting, justifying and spending budget for tools and equipment that do not meet the threshold for capitalization. Another key compensating control is the inability of staff to perform their service functions without the proper tools and equipment. In addition, the City has adopted Employee Values that require all employees to "Be Accountable and Act with Integrity", holding employees responsible for the stewardship of public funds and organizational resources. Employees are evaluated on their work performance (using City equipment and tools) and other employee values as part of their annual performance review. Any performance failure identified by use of these internal controls (excess budget, poor work performance due to equipment or tool misplacement, or employee values failure) should result in management and/or employees being held accountable and immediate corrective actions taken. The strength of these controls is evidenced by the fact that no instances of malfeasance, theft or improper use of equipment or tools were cited in the audit findings.</p> <p>Defining high-risk items is most appropriately handled in each department. It is difficult for Accounting or Internal Audit to define these items without clear knowledge of all of the distinct operations of the City. Each department and each supervisor must be responsible for identifying, tracking and safeguarding its own unique assets that they determine to be high-risk and which do not meet the criteria of a capital asset for financial statement purposes. Administrative Regulation 226 does contain the following statement as part of the purpose of the regulation, "Safeguard assets against theft and misuse. However, this regulation is not intended to supercede or alleviate the need for management and supervisory controls over portable equipment or supplies/inventory that might be susceptible to misappropriation."</p> <p>Responsible Party: Accounting Division Completed By: 06/30/05</p>

No.	Recommendations and Management Response
	<p>Auditor Comment: The lack of any references to malfeasance, theft, or improper use of equipment or tools is not necessarily an indication of the strength of compensating controls. In this case it is a direct reflection of the fact that there is no central list, or lists, of non-capital equipment or tools that should be present as well as their locations. Without such information, we could not determine the universe of items that should be present and, as a result, we concluded that testing for the continued presence of items would not be practical or effective. Therefore, such tests were not conducted and this recommendation was developed.</p>
2	<p>Review equipment item entries on the capital asset list and for instances in which the entry appears to be for a group of assets, make a determination as to whether the items are network or system related. For groups of assets not network or system related, assess the feasibility of obtaining the necessary documentation for each of the items in order to make the determination of whether each individual asset meets the criteria for capitalization. For assets that are determined to be part of a network or system, establish responsibility for the party that will be responsible for maintaining a detailed listing of the individual assets that make up the network or system.</p>
	<p>Management Response: Completed. It is important to note that the City's external financial statement auditors have always given the City a "clean opinion" on the accuracy and recordation of capital assets. However, current asset information records are limited by an asset listing that has been developed during the entire 54-year history of the City and consists of records developed by disparate systems and personnel. The total value of assets for the City at the end of the fiscal year 2003/04 was in excess of \$2.9 Billion. Access to records for research is limited for past years as well as the staff time available to perform such work. Re-creating 54 years of data would be a laborious, time consuming, and expensive task and the benefits derived would not outweigh the costs for the citizens of the city. Accounting has made significant strides to include additional identifying information for all assets currently being recorded and will continue to improve the processes prospectively.</p> <p>Responsible Party: Accounting Division Completed By: Ongoing</p>
3	<p>Identify and implement a mechanism to obtain detailed supporting documentation for each equipment item purchased through a CIP cost center and use the documentation to determine whether each item merits being recorded onto the capital asset list. However, individual evaluation is not necessary if the items are determined to be part of a system or network.</p>
	<p>Management Response: Concur. Accounting and Budget staff are currently working in partnership to strengthen the process for capitalized assets obtained through the CIP process. New procedures and processes are being developed to ensure that greater detail is available on the capital asset listing.</p> <p>Responsible Party: Accounting/Budget Divisions Completed By: 09/9/05</p>

No.	Recommendations and Management Response
4	Develop a process for recording the composite value of the library collection onto the capital asset list.
	<p>Management Response: Completed. However, the City has chosen not to record collections (art or library books) because they meet the conditions to be excluded under Financial Accounting Standards Board Statement No. 116 and guidelines implemented for Governmental Accounting Standards Board Statement No. 34. Although individual items within the collection may change over time, these collections are maintained in perpetuity to be used for purposes other than financial gain and any revenues received from the sale of the assets is used to replenish the collections. Depreciating these types of assets would artificially increase the City's expenses and would not accurately reflect the true intent of the collections.</p> <p>Responsible Party: Accounting Division Completed By: N/A</p> <p>Auditor Comment: The decision as to whether to record the library collection as a capital asset rests with management. However, we believe that doing so would be consistent with the treatment of Information Systems composite assets. In addition, as long as the library collection is treated as a non-capital asset, it will not be subject to any inventory verification requirements.</p>
5	Develop and implement a process whereby all capital equipment is the subject of inventory verification requests. Ensure that sufficient detail is provided to the departments to communicate the equipment they are to specifically verify.
	<p>Management Response: See response to recommendation No. 2.</p> <p>Responsible Party: Accounting Division Completed By: Ongoing</p> <p>Auditor Comment: AR 226 requires that an inventory of capital equipment be done every three years, resulting in a current deadline of July 2006. Compliance with this requirement will not be achieved without sufficient detail that identifies what is to be inventoried. If this is the case, management should acknowledge that the inventory will not be completed and consider modifying AR 226 to reflect this.</p>
6	Establish a requirement to inventory high-risk capital items annually. In identifying high-risk items, consider the dollar amount, criticality to operations, and susceptibility to theft or fraud.
	<p>Management Response: Concur. Administration Regulation 226 will be revised to include wording encouraging verification of high-risk capital assets as defined by the AR on an annual basis.</p> <p>Responsible Party: Accounting Division Completed By: 06/30/05</p>

No.	Recommendations and Management Response
7	Require department responses to include a statement as to whether their verification process complied with the requirements set out in AR 226.
	<p>Management Response: Concur. A statement will be added to the reports sent to Departments for verification.</p> <p>Responsible Party: Accounting Division Completed By: 06/30/05</p>
8	Obtain detail on all capital equipment acquisitions in order to make item-by-item determinations of what should be tagged.
	<p>Management Response: Concur. Traditionally the City has followed these procedures for items purchased with operating funds. The City will expand our current procedures to include assets acquired with capital project funding. See response to item recommendation No. 2.</p> <p>Responsible Party: Accounting Division Completed By: Ongoing</p>
9	Limit use of asset tags to only capital equipment. If non-capital items are to be tagged, develop separate procedures and use separate tags.
	<p>Management Response: Concur. Accounting will provide warehouse personnel with additional guidance to decide which items should be tagged and not tagged.</p> <p>Responsible Party: Accounting/Warehouse Completed By: 06/30/05</p>
10	Establish a process that requires the collection and retention of asset tags from the Warehouse, upon disposal of capital equipment, in order to evidence that the assets were actually disposed of through appropriate channels.
	<p>Management Response: Concur. Asset tags will not be removed if the removal will cause damage or hurt the resale value of the item. In these instances, Warehouse personnel will note the numbers and communicate the disposal to Accounting.</p> <p>Responsible Party: Accounting/Purchasing Completed By: 06/30/05</p>
11	Obtain the required detail for equipment acquisitions to record the required information.
	<p>Management Response: See response to recommendation No. 3.</p> <p>Responsible Party: Accounting/Budget Divisions Completed By: 9/9/05</p>

No.	Recommendations and Management Response
12	Develop procedures for identifying the locations of capital equipment and record the information onto the capital asset list.
	<p>Management Response: Concur. This requirement has been met through the use of an identifying cost center within the fixed asset records. The cost center allows for Financial Services to identify the general location of each asset by Department. Adding specific locations and subsequently changing them every time an item is moved will result in a greater cost than the benefit derived and is not an efficient use of the City's resources.</p> <p>Responsible Party: Accounting Division Completed By: Completed</p> <p>Auditor Comment: Currently, AR 226 has a requirement that asset location (department, building, room, etc.) be included on the capital asset list. If there is no expectation that this information be recorded, then the AR should be modified to eliminate the noncompliance issue.</p>
13	Document the Warehouse supplies inventory procedures as well as the records that are to be retained to evidence the results.
	<p>Management Response: Concur. The Warehouse will develop comprehensive procedures for the inventory of the Warehouse. The procedures will document when the inventory is to be performed, how the inventory is to be performed, and the records to be retained.</p> <p>Responsible Party: Warehouse Division Completed By: 04/15/05</p>
14	Continue to work toward eliminating vendor supplies from being reported in City financial statements.
	<p>Management Response: Concur. Prior to the commencement of this audit, staff discovered this issue with the consignment inventory primarily held for the Water Department (meters and fittings). Accounting will only include inventory, which has been purchased and is considered a current asset, as part of future financial statement preparation.</p> <p>Responsible Party: Accounting/Purchasing Completed By: 06/30/05</p>
15	Document the procedures for developing the statement of values related to insuring the City's tangible capital assets.
	<p>Management Response: Concur. Will document the procedures and judgments that go into developing and maintaining the statement of values.</p> <p>Responsible Party: Risk Management Completed By: 08/01/05</p>

No.	Recommendations and Management Response
16	Determine if Accounting will be recording the location of the City's capital equipment and if so, use the list in identifying the contents of buildings for insurance purposes.
	<p>Management Response: See response to recommendation No. 12.</p> <p>Responsible Party: Accounting Division Completed By: Completed</p> <p>Auditor Comment: See comment on recommendation No. 12.</p>

BACKGROUND

To be considered tangible, an item has to have a physical existence; to be considered an asset, it has to have value. By definition, any tangible asset that benefits more than one fiscal period could be classified as a capital asset. For business-like activities, this action permits the systematic and rational allocation of the asset's cost over its estimated useful life, where appropriate, through depreciation. It also provides a means to safeguard the investment that has been made by creating a record of the purchase. As a practical matter, though, an organization will expense lower cost assets because the initial investment does not warrant the calculation of depreciation or additional efforts to safeguard the item. The dollar level at which this distinction is made will vary based on the need of a particular organization. At the City, this threshold is set out in AR 226, "Capital Assets: Acquisition, Maintenance, and Disposal of Capital Assets."

This AR defines capital assets as land, buildings, improvements other than buildings, infrastructure, machinery and equipment, or networks or systems with unit costs greater than \$5,000 and useful lives greater than one year. Under this definition, a capital asset could be one single item or multiple dissimilar items that, when put together, create value to the organization. For City operations this includes, for example, the computer network, the infrastructure necessary to provide water service, and the street system.

Recording Capital Equipment Activity

The Financial Services Department records capital assets. In practice, the Accounting Division of this department carries out this role. At a minimum, AR 226 requires the following information to be captured on the capital asset list:

- a) Location—department, building, room, etc.
- b) Asset number – this number specifically identifies the asset with the City's financial accounting software.
- c) Description—name, model number, size, etc.
- d) The fund (and program, if applicable) from which the item was purchased.
- e) In-service date—date that the asset was received or constructed.
- f) Cost—actual cost for purchased items and estimated fair market value at date of acquisition for donated assets. If actual cost for purchased items cannot be determined, estimated historical cost (properly supported) may be used. If the fair value of the asset at the date of donation is unknown, it may be estimated. Documentation supporting the cost or estimated cost should be retained for the life of the asset.

Identifying Capital Equipment Acquisitions

Capital equipment acquisition is identified in several ways but the majority of activity is identified by periodic review of and reconciliation with available reports. An Accounting Coordinator reviews monthly and year-end operating center expenditure reports to identify items that appear to warrant being placed onto the capital asset list. All expenditures over \$5,000 are scrutinized and, if it looks like a capital asset has been purchased, the Accounting Coordinator will obtain the transaction's supporting documentation (usually an invoice) from Accounts Payable. Based on this documentation and, if necessary, user department insight into the useful life, a decision will be made as to whether or not the item should be recorded onto the capital asset list. The Accounting Coordinator retains documentation used in this process to support the related decisions. The total value of capital equipment recorded in operating centers was slightly in excess of \$4.8 million as of July 1, 2004.

Capital equipment may also be added as the result of capital improvement projects (CIP). Annually, the Accounting Coordinator reviews a spreadsheet, maintained by the CIP Coordinator, of year-to-date expenditure and cumulative balance information for each CIP cost center. If the breakout information listed indicates that equipment was purchased, the amount will be listed on the capital asset list. Detailed supporting documentation is not obtained or reviewed during this process. As a result, the asset may be an aggregate amount consisting of multiple items. Approximately \$40.4 million of capital equipment was recorded in CIP cost centers as of July 1, 2004.

Other activities, such as receipt of items at the Warehouse or review of the Council Agenda by the Accounting Director may identify acquisitions that need to be researched.

Identifying Capital Equipment Disposals

The Accounting Coordinator reviews monthly and year-end revenue reports looking for capital equipment that was sold. If anything is identified, the item(s) is removed from the capital asset list. In addition, the Accounting Coordinator uses an annual verification, discussed later in this section, to identify items that need to be removed.

Non Capital Asset Activity

With limited exceptions, there is no centralized guidance for recording or tracking assets that have useful lives greater than one year but which fail to exceed the \$5,000 capitalization threshold. There is no centrally maintained inventory of these items and no requirement for user areas to maintain their own inventory. AR 226 does, however, establish requirements for Fleet and the Warehouse to prepare and maintain a current list of supplies on hand even

though these items do not meet the capitalization threshold. Both areas are required, at a minimum, to perform a full physical inventory of its supplies at least once a year. Warehouse personnel conduct annual counts of each supply item and needed adjustments are made to reconcile the actual physical inventory of supplies to Accounting's general ledger record for the items. Procedures for Fleet are discussed in the report dealing with Fleet Assets.

Identification of Capital Assets

AR 226 requires that all machinery and equipment items with unit costs of \$5,000 or more be tagged, marked with an identifying number, or specifically identified by some other means such as a serial number. In most cases, sequentially numbered metallic adhesive tags are used to address this requirement. The party responsible for providing the tag is dependent on the point at which the asset is received within the City. If the asset is received through the Warehouse, the tag is attached there. The tag number, along with a description of the asset, Purchase Order number, and date received is forwarded to Accounting. If the asset is not received through the Warehouse, Accounting is responsible for assigning a tag. The Accounting Coordinator sends the asset tag, along with instructions on how to apply it, to the end user of the asset. In some instances, capital machinery and equipment will not be tagged because the nature of the item does not provide a location to which the adhesive can adhere. In these cases, only an asset number is assigned to the item with nothing physically placed on the item.

Capital Equipment Physical Inventory Requirements

AR 226 requires that each department conduct a physical inventory of all its capital equipment at least every three years and that appropriate changes be recorded on the capital asset list. To accomplish this, a current list of items, by location, is to be provided to each departmental advisor or budget liaison. The user department is to then verify whether equipment on the list is still present. If equipment, in the possession of the user department is not listed, a notation is to be added to the list. Once done, the list is to be returned to Financial Services.

In practice, an Accounting Coordinator initiates an annual process for departmental verification of capital equipment on record as assigned to their operating centers (as opposed to the assets recorded in CIP cost centers).

OBJECTIVES, SCOPE, AND METHODOLOGY

The objectives of this audit were to:

- Determine if the control environment is sufficient to ensure that the City's financial system accurately reflects tangible capital property.
- Determine if compliance is achieved with City Code and ARs that address the acquisition, maintenance, and disposal of tangible capital property.
- Determine if procedures are sufficient to ensure adequate identification of tangible capital assets for insurance coverage.

The scope of this audit was limited to the objectives noted above. To address these objectives we reviewed ARs and department procedures, where available, to gain an understanding of requirements and processes. We surveyed each department to identify guidance and controls they may have established, as well as to identify available documentation that evidenced the control activities exercised over tangible assets that fall below the \$5,000 capitalization level. We interviewed the Accounting Director and the Accounting Coordinator responsible for maintaining the capital asset list, in order to gain an understanding of the process for recording and tracking capital equipment. We also interviewed an Accounting System Integrator to obtain an understanding of the process for verifying signature authority for capital equipment requisitions initiated through the City's financial system known as SmartStream. The Accounting Manager was interviewed to gain an understanding of the processing of invoices for payment. We also interviewed the Risk Management Director to determine whether procedures are sufficient to ensure adequate identification of tangible capital assets for insurance coverage. To obtain an understanding of the physical inventorying of the Warehouse supplies, we interviewed the Warehouse Operations Manager and the Accounting Systems Integrator involved with the process. We also discussed capital asset tagging responsibilities with the Warehouse Operations Manager.

To test procedures, we reviewed documentation to verify that year-end procedures and reconciliations were being done. We obtained the list of capital acquisitions made in FY 03/04 and traced equipment acquisitions associated with operating centers to supporting documentation indicating that the assets were received within the City and traced capital asset disposals for FY 03/04 to documentation to support the removal.

To test that capital equipment is tagged as required, we identified capital equipment acquired during FY 03/04 and attempted to trace each item to an entry in the asset tag log maintained by the Accounting Coordinator. For

equipment items not in the tag log, we obtained supplemental information from the Accounting Coordinator to explain the situation.

To test the annual capital equipment verification, we reviewed responses from departments and interviewed staff in areas that, according to financial records, had \$100,000 or more of capital equipment as of July 1, 2004.

To test controls on the authorization of purchases, we obtained a list of City personnel with requisitioning access to SmartStream. We traced each of these individuals to a current Access Request Form signed by each employee's upper level manager.

Audit work was conducted in accordance with generally accepted government auditing standards as they relate to expanded scope auditing in a local government environment and as required by Article III, Scottsdale Revised Code, Section 2-117, *et seq.* Survey work began in January and audit testing took place in February and March 2005, with Ramon Ramirez conducting the work.

SURVEY PHASE

Finding: Controls are not sufficient to safeguard high-risk tangible assets that do not meet the \$5,000 capitalization threshold but which have useful lives in excess of one year.

Criteria:

Prudent business practice requires that an organization protect its assets. Internal controls should be designed to provide reasonable assurance regarding prevention, or prompt detection, of unauthorized acquisition, use, or disposition of an agency's assets. Policies and procedures are part of the control activities that enforce management directives.

Condition:

There is no requirement, in the form of an AR, for City employees to track centrally, or at the departmental level, tangible assets that do not meet the threshold for capitalization.

In absence of established citywide guidance, we questioned staff in 20 work areas and found only 10 instances in which assets below the capitalization level were tracked. Interviews revealed that items tracked varied widely, oversight exercised was not consistent, and tracking responsibilities spanned a variety of supervisory levels. Only 2 areas reported written procedures for tracking assets.

Cause:

Management decision.

Effect:

High-risk assets that do not meet the capitalization threshold but which have a useful life beyond one year may be subject to theft and/or loss that goes undetected. Moreover, the City has no historical record of items purchased, the area responsible for the item, or, ultimately, the disposal when no longer needed. Records of assets destroyed in a fire or other disaster would not exist in a form that could easily be retrieved.

Recommendations:

Develop citywide guidance that establishes responsibility for assessing the need to track high-risk tangible equipment that does not meet the \$5,000 capitalization threshold but which have useful lives in excess of one year. Provide direction on what items may be considered high risk and thus merit establishment of safeguarding controls. Either establish controls that should be implemented at the user level or provide a list of potential control techniques that could be implemented at the discretion of the user department.

OBJECTIVE 1: DETERMINE IF THE CONTROL ENVIRONMENT IS SUFFICIENT TO ENSURE THAT THE CITY'S FINANCIAL SYSTEM ACCURATELY REFLECTS TANGIBLE CAPITAL PROPERTY.

Finding: Improvements are needed to ensure that:

- The capital asset list only includes items that meet the criteria set for inclusion.
- Appropriate documentation is retained.
- All City networks or systems have been identified for inclusion on the capital asset list.

Criteria:

The City's Accounting System should accurately reflect tangible capital equipment. Per AR 226:

- The Financial Services Department will prepare and maintain a current capital asset list for machinery and equipment with unit costs of \$5,000 or more and useful lives greater than one year.
- Networks or systems with unit costs greater than \$5,000 and useful lives greater than one year are also considered capital assets.

Condition:

Financial Services maintains a capital asset list that includes machinery and equipment. Many positive steps have been undertaken in an attempt to maintain a list that reflects accurate information. We verified that expenditure and revenue reports are reviewed to identify capital equipment acquisitions and disposals for the purpose of making required adjustments to the list. In addition, we verified that CIP cost center acquisition activity is reviewed to identify equipment aggregate totals that need to be added to the capital asset list. We also noted that FY 03/04 capital equipment additions were supported either by invoices and supplemental notes indicating that they met the capitalization requirements or by a CIP spreadsheet indicating the aggregate value of equipment to be capitalized. Supporting documentation was present to evidence that the City had actually received operating center equipment added to the capital asset list during FY 03/04. Likewise, documentation was available that supported the removal of equipment from the capital asset list.

Notwithstanding the above-mentioned activities, additional steps can be taken to increase the accuracy of the equipment information recorded in the capital asset list. We noted that in some instances aggregate amounts were capitalized for certain item classifications even when they did not appear to be

network or system related. For example, there were “modular furniture” entries in excess of \$95,000, \$17,000, and \$26,000. While it appears that current practice is sufficient to not add aggregate amounts to the asset list, these historical records continue to exist.

As well, equipment, recorded onto the capital asset list as a result of the CIP review, is recorded as an aggregate amount without review to determine whether individual items, making up the aggregate total, meet the capitalization requirements. We also noted, for CIP additions, detailed supporting documentation is not retained by the Accounting Coordinator to provide information that can be used for the required periodic verification.

Finally, we noted that the City’s library collection is not recorded on the capital asset list. While the individual items in the library collection may not have significant value, library officials estimate the total value of the collection at \$30 million. This represents a significant class of assets with expected useful lives greater than one year but which are not reported on the capital asset list. In addition, the City has an implied commitment to maintain the library collection for its patrons. By comparison, the composite amount recorded for Information Systems assets is approximately \$11.2 million. In that case, Information Systems maintains the list of assets that are included in the composite. A similar approach could be used for the library collection with a composite amount recorded on the capital asset list and the list of assets being maintained by the library.

Cause:

1. Past practice in recording assets was not as thorough in reviewing supporting documentation as what is currently in place.
2. Improvements in procedures have addressed many things but have not yet encompassed the detail necessary for CIP additions.
3. The library collection has not been considered a network of assets that merit inclusion on the capital asset list.

Effect:

There has been inconsistent treatment of like items in recording equipment onto the capital asset list. In some cases, individual items that do not meet the capitalization criteria may have been added to the list. While in another case, a significant network of assets has not been reported. As a result, there is no assurance that the list accurately depicts the City’s capital equipment.

Recommendations:

Review equipment item entries on the capital asset list and for instances in which the entry appears to be for a group of assets, make a determination as to whether the items are network or system related. For groups of assets not network or system related, assess the feasibility of obtaining the necessary documentation for each of the items in order to make the determination of whether each individual asset meets the criteria for capitalization. For assets that are determined to be part of a network or system, establish responsibility for the party that will be responsible for maintaining a detailed listing of the individual assets that make up the network or system.

Identify and implement a mechanism to obtain detailed supporting documentation for each equipment item purchased through a CIP cost center and use the documentation to determine whether each item merits being recorded onto the capital asset list. However, individual evaluation is not necessary if the items are determined to be part of a system or network.

Develop a process for recording the composite value of the library collection onto the capital asset list.

OBJECTIVE 2: DETERMINE IF COMPLIANCE IS ACHIEVED WITH CITY CODE AND ARS THAT ADDRESS THE ACQUISITION, MAINTENANCE, AND DISPOSAL OF TANGIBLE CAPITAL PROPERTY.

Finding: Steps have been taken to initiate an annual inventory of capital equipment but improvements are needed.
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Criteria:

AR 226 indicates that a physical inventory by each department of all equipment will be taken at least every three years and appropriate changes will be recorded on the capital asset list. The AR expands further by indicating the following:

Every three years, at a minimum, a current list of capital assets for all equipment items, by location, will be provided to each departmental advisor or budget liaison. The list will include each item's identification number, description, and location.

- a. Departments conducting a physical inventory should prepare written instructions that clearly indicate the procedures for taking the physical inventory. These instructions should be distributed to and reviewed with employees involved in the inventory process.
- b. The physical inventory should be carefully planned and supervised.
- c. Responsibility for the inventory should be assigned to a specific employee (a physical inventory officer). Personnel in each department may assist in taking counts.
- d. The departments should count items in a systematic manner so items are neither omitted nor counted more than once.
- e. Inventory counts will be observed or sampled by outside personnel to verify the accuracy and to negate internal department fraud.
- f. To provide an accurate count, movement of capital assets should be restricted during the inventory period. New acquisitions should be held and counted in the receiving department until cleared by the physical inventory officer for delivery to the appropriate user department.
- g. Items on the list should be initialed to indicate verification. Assets that are not included on the list should be added. Such items may include new acquisitions or transfers of equipment from another department. If an asset on the list cannot be located, the employee should make note of this on the list.
- h. Each departmental advisor/budget liaison should review the completed inventory list before submitting it to Financial Services. The review should

include an investigation and the resolution of problem assets. The departmental advisor/budget liaison should document the review by initialing and dating the list.

- i. Inventories should be observed, supervised or at least sampled by outside personnel, where practical, to verify accuracy and to negate internal department fraud.

Condition:

The effective date of AR 226 is listed as July 1, 2003. As a result, a requirement for an inventory to take place every three years indicates that the expectation is for the first inventory to be completed no later than July 1, 2006. However, Accounting has initiated a year-end process requesting that City department representatives verify the continued presence of capital equipment on record as being assigned to their areas.

Each department is sent a list of the capital equipment on record as being in their possession along with an e-mail that references the AR 226 inventory requirements. The e-mail also contains instructions requesting that the department representatives indicate whether the asset is still located in their center and, if not, that they indicate the date the asset was retired or explain what happened to the asset. There is also an expectation that the department representatives provide feedback on capital equipment in their area but which is not listed on the report sent to them. Once the information is returned to Accounting, needed adjustments are made to the capital asset list. The department responses are retained to support the addition or removal of equipment from the capital asset list.

As currently structured, though, the list sent out to the departments only contains capital equipment purchased through operating centers (slightly in excess of \$4.8 million as of July 1, 2004) and does not include capital equipment purchased through CIP cost centers (approximately \$40.4 million as of the same period). As a result, only 10.6 percent of the capital equipment recorded in Accounting's records is sent for verification. One obstacle to requesting verification of capital equipment obtained through CIP cost centers is the lack of detail that was discussed in Objective 1.

Another issue exists in the level of information provided to departments for the verification. Based on interviews with a sample of responding department representatives, an actual physical verification of items takes place provided they are given sufficient descriptive information to know what they are looking for. However, there are instances in which the equipment descriptions do not contain sufficient detail to completely identify the items that are the subject of the verification request. For example, one item on a list was described only as

“railroad equip” with a total cost of \$134,981. The department representative said that he responded that the equipment was still there because he knew of no railroad equipment that went away. In this particular case, the departmental representative has an item-by-item list that dates back to 1997 when he took over responsibility for the equipment. He does not have, however, documentation that would allow him to determine which items should be considered when reaching a conclusion that the \$134,981 worth of equipment on the capital asset list is still present.

There are other similar instances where department representatives indicated that their responses to the equipment queries were not based on physical verifications but their recollection that no such equipment had left their area. For example, one description was “modular furniture for project coordination” with a cited total cost in excess of \$78,000. Another description was “restaurant FF&E” (furnishings, fixtures, and equipment) with a cited cost in excess of \$193,000. In these cases, there is no clear indication of the specific items that were to be verified and in both cases the department representatives indicated their response was not based on a physical verification but on their historical knowledge that nothing with that general description had been disposed of.

Although there is a need to balance the control of assets and the cost of periodically verifying their presence, best practices indicate that it is not always practical to give the same treatment to each item. It may be desirable to assess the risk for various asset classes to determine the frequency of verifications. Equipment that is not portable, easily converted to personal use, and not critical to organization operations may not merit frequent verification. As a result, the three-year verification requirement may be appropriate. Conversely, items that have the opposite characteristics (high-risk items) should be verified more often.

Cause:

A comprehensive process for the physical inventory of all capital equipment has not been developed. In addition, the current level of detail captured on the capital asset list is inadequate for identifying all the equipment that needs to be verified (see Objective 1 for discussion on the lack of detailed information).

Effect:

A physical inventory of each department’s capital equipment will not be achieved under the current process. The potential for high-risk items to go unverified for an extended time exists. Compliance with AR 226 will not be achieved.

Recommendations:

Develop and implement a process whereby all capital equipment is the subject of inventory verification requests. Ensure that sufficient detail is provided to the departments to communicate the equipment they are to specifically verify.

Establish a requirement to inventory high-risk items annually. In identifying high-risk items, consider the dollar amount, criticality to operations, and susceptibility to theft or fraud.

Require department responses to include a statement as to whether their verification process complied with the requirements set out in AR 226.

<p>Finding: Improvements are needed to ensure that all capital equipment is tagged as required.</p>

Criteria:

AR 226 sets out the following requirements:

All machinery and equipment items with unit costs of \$5,000 or more should be tagged, marked with an identifying number, or specifically identified by some other means such as a serial number.

- a. If the asset is received through the Warehouse, at that point in time, the Warehouse will attach an asset ID number. This number, along with a description of the asset, PO number, and date received will be forwarded to the Accountant so that the asset can be entered into the inventory with consistent information. Tags should be numbered and numerically controlled.
- b. If the asset is not received through the Warehouse, the Accountant is responsible for assigning the inventory number. The asset tag, along with instructions on how to apply the asset tag will be sent to the end user of the asset. Tags should be numbered and numerically controlled.

AR 226 also establishes similar requirements for Information Systems assets and vehicles and equipment tracked by Fleet. However, as previously mentioned, those areas are the subjects of separate audit reports. The discussion herein will address the remaining capital equipment.

Condition:

Metallic adhesive asset tags are used to mark capital equipment with an identifying number if the nature of the item provides a location to which the adhesive can adhere. If a tag is not attached to a piece of capital equipment, an asset number is recorded for the item in Accounting's records. The tags are sequentially numbered as a control that permits identification of whether all tags and items are accounted for. Accounting controls the asset tags but they provide blocks of tags to the Warehouse so that they can meet their tagging responsibilities.

Both Accounting and the Warehouse maintain logs for tracking the issuance of asset tags. We noted a significant improvement, within the last year, in the information retained by Accounting in their tagging log. Currently, their log tracks the tag number, the date it was distributed, the date the asset was capitalized, the user department contact who was provided with the tag for affixing to the asset, a description of the asset, and the Accounting person who provided the tag. This level of information provides a trail for verifying that a capital equipment asset was tagged.

The Accounting Coordinator identifies the need for an asset tag and sends the actual tag to a user department representative who is then supposed to place it on the item. Within Accounting, the need for an asset tag is noted at the time the Accounting Coordinator identifies that capital equipment needs to be recorded onto the capital asset list. However, as discussed under Objective 1, there is no detail obtained on individual equipment purchased through a CIP cost center. As a result, this capital equipment is not identified for tagging within Accounting. The items may be tagged if the Warehouse receives them, however, there is no assurance that all CIP acquired equipment comes to the City in this manner.

Within the Warehouse the need for an item to be tagged is determined upon receipt of the item. The items tagged are noted on their log, which is periodically sent to Accounting so that they can also track the items. Any of the 5 Warehouse staff members may place the tag on the asset depending on who is there to receive the item. While Warehouse personnel are looking to place the tags on items that exceed the \$5,000 capitalization threshold, departments sometimes ask for a tag for something that costs less than that amount and the Warehouse will tag the item. While there may be merit to tagging assets that do not meet the capitalization threshold, the use of the capital equipment tags should be limited to use on items that meet the criteria. Tagging assets that do not fall under the AR 226 criteria may still be beneficial to identifying City property. However, the tags should not be within the numbering sequence reserved for capital equipment in order to preserve the integrity of the tracking process.

Currently, there is no requirement that the tags be reclaimed upon disposition of capital equipment. Doing so would allow for all tags in the sequence to be accounted for and thus facilitate capital equipment tracking. In addition, requiring that the tag be removed by the Warehouse and returned to Accounting would provide a level of assurance that the asset was disposed of in accordance with City Code restrictions that only permit the Purchasing Director to dispose of surplus personal property.

Cause:

The Accounting Coordinator responsible for asset tagging does not obtain insight into each individual capital equipment item acquired by the City.

A separate process has not been developed for tagging equipment that does not meet the capitalization threshold.

The current AR 226 requirements do not identify the need to retrieve asset tags upon equipment disposal.

Effect:

All capital equipment is not tagged and, as a result, may not be safeguarded as intended.

The integrity of the numerical sequencing of the tags is not maintained because some tags are used for non-capital items and, as a result, the capital equipment tracking process may be impaired.

Not requiring the return of tags from disposed of equipment may lead to inappropriately removing equipment from the capital asset list. Accounting may remove equipment from the capital asset list based on feedback from departments that the item is no longer in use in their area. While the department may have sent the item to the Warehouse for disposal, it is possible that the item may have been returned to use in another area and not actually disposed of.

Recommendations:

Obtain detail on all capital equipment acquisitions in order to make item-by-item determinations of what should be tagged.

Limit use of asset tags to only capital equipment. If non-capital items are to be tagged, develop separate procedures and use separate tags.

Establish a process that requires the collection and retention of asset tags from the Warehouse, upon disposal of capital equipment, in order to evidence that the assets were actually disposed of through appropriate channels.

Finding: All required capital asset information is not captured in the Accounting records.

Criteria:

AR 226 requires that the Financial Services Department prepare and maintain a current capital asset list that will, at a minimum, include the following:

- a) Location—department, building, room, etc.
- b) Asset number – this number specifically identifies the asset with the City’s financial accounting software.
- c) Description—name, model number, size, etc.
- d) The fund (and program, if applicable) from which the item was purchased.
- e) In-service date—date that the asset was received or constructed.
- f) Cost—actual cost for purchased items and estimated fair market value at date of acquisition for donated assets. If actual cost for purchased items cannot be determined, estimated historical cost (properly supported) may be used. If the fair value of the asset at the date of donation is unknown, it may be estimated. Documentation supporting the cost or estimated cost should be retained for the life of the asset.

Condition:

For equipment, we noted that Accounting’s capital asset list does contain the majority of the required information when the detailed supporting documentation for the asset acquisition is obtained for review. However, as discussed under Objective 1, there are numerous instances in which detailed information is not obtained for equipment acquisitions. These acquisitions may involve numerous pieces of equipment but the detail on each piece of equipment is not captured. In these situations, only an in-service date, a general description, cost center, and aggregate cost information is captured. An asset number is also recorded, but it is a single number for what is potentially a group of assets that are not necessarily similar to each other. While cost center information can provide insight into the department to which equipment is assigned, it does not provide location detail such as the building or room that physically houses the items.

Cause:

Sufficient insight is not obtained for each equipment item acquired. Location information has not been pursued for recording onto the capital asset list.

Effect:

Compliance is not achieved with AR 226 requirements. The lack of descriptive information and locations present an obstacle to safeguarding capital equipment and any process for verifying the continued presence of the items.

Recommendations:

Obtain the required detail for equipment acquisitions to record the required information.

Develop procedures for identifying the locations of capital equipment and record the information onto the capital asset list.

Finding: Warehouse supplies inventory process needs better documentation to evidence results.

Criteria:

AR 226 addresses Warehouse supplies and indicates that the Warehouse will:

1. Prepare and maintain a current list of supplies on hand.
2. Update their listing each time there is a change in inventory.
3. Determine the frequency of physical inventories but will, at a minimum perform a full physical inventory at least once a year. Physical inventories are required for supplies maintained internally and for service vehicles that leave City property.
4. Provide for safeguarding of supplies on service vehicles.
5. Reconcile physical inventory of supplies to general ledger at least once a year.

Condition:

The supplies inventory is maintained on the City's SmartStream financial system. It is updated automatically based upon supply requests completed by user department personnel who have authorization to access the system. Field personnel, who do not have access to a computer, come to the Warehouse and fill out a hardcopy stores requisition to order supplies. Warehouse personnel enter the requisition into the system. Requested supplies are pulled by Warehouse personnel and delivered to the requestors.

Physical access to the supplies is limited by locked gates or through the Warehouse office. None of the supplies are kept on vehicles. All Warehouse staff have keys and so does the guard shack, which may have to let a crew in for after hour supply needs. In such cases, the guard will record what was taken on a hardcopy form and Warehouse personnel will enter the information into the system when they arrive.

Every July, Warehouse personnel take a physical inventory of the supplies but the inventory procedures are not documented. We verified that documentation was present to evidence the July 2003 inventory and that the required adjustments were made. However, documentation for the July 2004 inventory was not complete. While a summary of the counts was present as well as an indication that the inventory was adjusted, tabulation sheets to evidence that actual counts were not produced.

It also came to our attention that a portion of the supplies maintained in the Warehouse are not the property of the City but are actually on consignment

from a vendor. These items are recorded in SmartStream to make them available to potential users who may need to order them. However, these items were also reported on the City's financial records as part of the \$207,000 Warehouse supplies inventory. Accounting personnel estimate the portion of this figure, attributable to vendor supplies, was approximately \$60,000. Accounting indicated that they were aware of this situation before we brought it up. They have been working to correct the problem before the June 30, 2005, financial statements are released.

Cause:

The lack of management initiative to document inventory procedures and to establish document retention criteria.

The lack of communication that vendor supplies were included in the supplies inventory maintained on the SmartStream system.

Effect:

Without written inventory procedures, the process could be inconsistent from year to year. In addition, inefficiencies could occur in the inventory process due to staff turnover that results in the need for new staff to identify the steps that need to take place.

Without documentation to evidence the person counting the inventory, the date the count took place, and the results of the count, there is no assurance that the correct counts were recorded and that the inventory records were properly adjusted.

City financial statements misstate the supplies inventory.

Recommendations:

Document the Warehouse supplies inventory procedures as well as the records that are to be retained to evidence the results.

Continue to work toward eliminating vendor supplies from being reported in City financial statements.

OBJECTIVE 3: DETERMINE IF PROCEDURES ARE SUFFICIENT TO ENSURE ADEQUATE IDENTIFICATION OF TANGIBLE CAPITAL ASSETS FOR INSURANCE COVERAGE.

Finding: The approach to identifying tangible property for insurance purposes appears to be reasonable for buildings but additional detail is needed to properly safeguard capital equipment. In addition, procedures need to be documented.

Criteria:

To properly safeguard tangible capital assets and to help ensure that the City pays the appropriate premium for its insurance coverage, the list of assets that are to be insured (statement of values) should be as accurate as possible.

Condition:

Annually, Risk Management (Risk) submits a statement of values to the City's property insurer(s) as an indication of the assets that are to be covered. The City self-insures vehicles against damage or theft. For catastrophic events, the City has coverage up to \$7 million for damage to an accumulation of vehicles (such as hail or fire). To identify City buildings that need to be included on the statement of values, Risk obtains a master list of buildings and square footage from the City's Facilities Maintenance Division (according to Risk this is the only available source listing all City buildings). Risk consults with the City's insurance broker to come up with a per square foot cost based on building usage. The numbers are then extended out and the information is placed onto the statement of values. Related procedures are not documented.

During this work, staff reported that building costs are available for new properties but estimates have to be developed for older buildings. As part of this effort, the City has contracted a vendor to identify and appraise City properties. The Risk Director said that he would be reviewing the results to determine their usefulness for insurance purposes.

According to the Risk Director, the City does not need to include the value of computers and software on the statement of values. Instead, the City purchases blanket coverage for these items based on the valuation information he obtains from Information Systems personnel.

For coverage on building contents, Risk does not have information on the type or quantity of equipment or furnishings within each building. For the statement of values, building contents are estimated based on usage. Current coverage includes a \$100,000 deductible per loss and, as a result, the Risk Director

stated that he would not recommend listing anything under \$150,000. Again there are no written procedures for arriving at estimates of building contents.

The Risk Director stated that possible inaccuracies in estimated contents are mitigated by two factors. One is a clause that says that if we inadvertently miss something, the insurer will pay out but we have to pay three years worth of premiums retroactively. The second is blanket insurance coverage of \$125 million for any one loss.

Cause:

Written procedures have not been developed due to a lack of management emphasis.

The equipment contained in each building is not specified due to the lack of an available record of the equipment by location.

Effect:

The lack of written procedures can lead to inconsistencies in the development of the statement of values. In addition, inefficiencies could occur in the process if cognizant staff leave the City and new staff have to reconstruct the process.

Even though there may be mitigating issues to not having an accurate record of the contents of a building, claims can only be submitted for equipment actually lost. In some instances, the items lost may be readily ascertainable by a visual inspection of the damaged area. There are, however, some potential scenarios where the previous contents of a building may not be reconstructed through a visual inspection.

Recommendations:

Document the procedures for developing the statement of values related to insuring the City's tangible capital assets.

Determine if Accounting will be recording the location of the City's capital equipment and if so, use the list in identifying the contents of buildings for insurance purposes.

APPENDIX A

MANAGEMENT RESPONSE

MEMORANDUM

April 21, 2005

TO: Cheryl Barcala, City Auditor

FROM: Craig Clifford, Chief Financial Officer
Lisa Murphy, Accounting Director

RE: Tangible Property Asset Management Report No. 0407B

The attached action plan is in response to Audit No. 0407B relating to the Tangible Property Asset Management Report.

As noted in the audit, prior to the commencement of the audit, staff in Accounting had initiated steps to improve the tracking and recording of the City's capital assets. As part of our evaluation of responses, we remained mindful that internal controls must be viewed from a cost/benefit perspective from the organizational standpoint, given the limited resources and staff available to establish, maintain and enforce those controls.

C: Jan Dolan, City Manager
Neal Shearer, Assistant City Manager
Monroe Warren, Purchasing Director
Myron Kuklok, Risk Director